97-84011-24

Osgood, Roy Clifton

Statement of the First National Bank of Chicago...

[n.p.]

[1916]

97-84011-24
MASTER NEGATIVE #

COLUMBIA UNIVERSITY LIBRARIES
PRESERVATION DIVISION

BIBLIOGRAPHIC MICROFORM TARGET

ORIGINAL MATERIAL AS FILMED - EXISTING BIBLIOGRAPHIC RECORD

336.24
Z
v.2

[Osgood, Roy Clifton]
Statement of the First national bank of Chicago and the First trust and savings bank of Chicago, in favor of deduction-at-source and in answer to the "discussion" of June 17, 1916, by A. E. Holcomb and A. C. Rearick of suggestion of repealing collection-at-source provisions of Federal income tax law and substitution of information-at-source. [n. p., 1916]
cover-title, 41 p. 25½cm.
Signed: Roy C. Osgood, counsel.
1. Income tax — U. S. 2. Holcomb, Alfred Eggleston, 1867– 3. Rearick, Allan Chamberlain, 1874– I. Chicago. First national bank. II. First trust and savings bank, Chicago. III. Title.
Volume of pamphlets.
Copy in
A 17-200
(Continued on next card)
Title from Leland Stan- ford Jr. Univ. Printed by L. C.

cOsgood, Roy Clifton, Statement of the First national bank of Chicago ... c1916, (Card 2)

308
Z
Box 48
Another copy. c1916,

Copy in

RESTRICTIONS ON USE: *Reproductions may not be made without permission from Columbia University Libraries.*

TECHNICAL MICROFORM DATA

FILM SIZE: 35mm REDUCTION RATIO: 11:1 IMAGE PLACEMENT: IA (IIA) IB IIB

DATE FILMED: 2-4-97 INITIALS: MS

TRACKING # : MSH 21090

FILMED BY PRESERVATION RESOURCES, BETHLEHEM, PA.

STATEMENT OF THE FIRST NATIONAL BANK OF CHICAGO AND THE FIRST TRUST AND SAVINGS BANK OF CHICAGO, IN FAVOR OF DEDUCTION-AT-SOURCE AND IN ANSWER TO THE "DISCUSSION" OF JUNE 17, 1916, BY A. E. HOLCOMB AND A. C. REARICK OF SUGGESTION OF REPEALING COLLECTION-AT-SOURCE PROVISIONS OF FEDERAL INCOME TAX LAW AND SUBSTITUTION OF INFORMATION-AT-SOURCE.

ANSWER

TO THE "DISCUSSION" OF JUNE 17, 1916, BY A. E. HOLCOMB AND A. C. REARICK OF SUGGESTION OF REPEALING COLLECTION-AT-SOURCE PROVISIONS OF FEDERAL INCOME TAX LAW AND SUBSTITUTION OF INFORMATION-AT-SOURCE.

This ANSWER made on behalf of The First National Bank of Chicago and the First Trust and Savings Bank, Chicago, is desirous of accomplishing two things, namely:

1. The retention of the deduction-at-source feature of the Federal Income Tax Law and the abandonment of the suggested information-at-source substitution in its place.

2. The repeal of that portion of paragraph E of Section II of the Income Tax Law reading as follows:

> "nor shall any contract entered into after this Act takes effect be valid in regard to any Federal income tax imposed upon a person liable for such payment."

These banks contend that if the above provision in the act or a similar one is retained, and if deduction-at-source is abolished, that the corporation bond market of the United States will be seriously affected and that corporate bonds will be placed at a great disadvantage in the eyes of investors as against corporate stocks, individual mortgage loans and municipal bonds, and that the only remedy to equalize the situation will be an increase of the interest rate on corporation bonds. These banks are vitally interested in protecting a market for corporation bonds they have built up among their thousands of customers over a period of some forty years.

In taking this stand these banks support the same position taken by the Investment Bankers Association of America, the membership of which comprises practically every bank, partnership or corporation of standing in the United States engaged in the sale of municipal and corporation bonds.

These banks would naturally prefer that the entire system of collection-at-source be abolished without the substitution of information-at-source, but if Congress deems it necessary to have either one they consider collection-at-source by far the preferable.

The DISCUSSION is divided into six numbered parts and a conclusion. The ANSWER follows the same order, quoting the principal points raised in the DISCUSSION and commenting upon each.

I.

PRELIMINARY STATEMENT.

This introduction to the DISCUSSION states that Messrs. Holcomb and Rearick are members of the Committee of the National Tax Association on the Federal Income Tax and that the DISCUSSION is an amplification of the report of that Committee made in August, 1915. It may be assumed from the preliminary statement that their position is taken in connection with the corporations they represent as they submit the DISCUSSION solely as individuals and "without any suggestion that it represents the views of other members of the Committee or that it is authorized by the Association." It is our understanding that these gentlemen represent some of the railway interests and a certain class of public utility interests.

II.

NATURE OF INCOME TAXES AND METHODS OF COLLECTION.

1. DISCUSSION, p. 3. "The vital matter is one of administration pure and simple—nothing else is before us or should be before us."

ANSWER: We submit that the first question for Congress to consider is the one of administration, but that the question of administration cannot be separated from its effect upon the business of the country. The DISCUSSION as a whole admits this by concentrating its argument upon the effect of the present method of administration of the law through collection-at-source upon the so-called tax free covenant regarding the payment of interest on corporation bonds. By exempting municipal bonds from its provisions the Income Tax Law has caused thousands of investors to seek this class of securities and has greatly increased the market for these bonds. The requirement of the filing of exemption certificates with the collection of interest coupons from corporation bonds has caused intense dissatisfaction among the holders of these securities who are loath to disclose their ownership and who resent the annoyance these certificates cause. This has caused thousands of them to change their investments to stocks and individual mortgage notes where no certificates are required and to municipal bonds where no certificates are required and which are not taxable at all. The sellers of stocks, mortgage notes and municipal bonds have used the situation as a strong selling argument in favor of these securities. The only strong point the sellers of corporation bonds have to offset this condition is a higher interest and the benefit of the tax-free covenant. If the benefit of the tax-free covenant is removed the only answer will

be to increase interest rates on corporation bonds, which can be done on practically only new issues, leaving the enormous amounts of old issues outstanding at a great disadvantage.

We think that the practical effect of substitution of information-at-source for deduction at-source will mean a reduction of practically a million dollars of expenditure a year to the railway companies alone in the United States by relieving them from the liability under their tax-free covenants in bond issues. The railway companies pay annually about $400,000,000 in interest upon their bonds and similar obligations. The normal tax of one per cent. upon this interest is $4,000,000 a year. It is estimated that by means of individual exemptions, corporate, partnership and non-resident alien holdings of these bonds, the railway corporations are obliged to pay annually only about one-fourth of the normal tax upon their bond interest, and this amounts to practically $1,000,000. The railroads have an established market for their bonds through the savings banks of the eastern states, whose laws specifically allow investments in these bonds, through banks, trust companies and insurance companies, large banking partnerships and non-resident aliens, none of whom can take advantage of the tax-free covenant. The result is their bond market is less affected by the presence or absence of the tax-free covenant. The general run of industrial and public utility corporations throughout the country depend more upon a market of individual investors and their bond market is vitally affected by this clause.

2. DISCUSSION, pp. 4 and 6. "All students agree that a personal income tax cannot readily be shifted but tends to stay where placed. This is perhaps the most important point to be remembered in this discussion." "Space forbids elaboration of this very important phenomenon observable in the operation of all taxation, but we remind ourselves of the fundamental advantage of the income tax which, in its proper form, is a direct and unshiftable tax, which indicates incidentally how necessary it is to preserve that feature and how fatal it is if opportunity for shifting be given and if great care be not taken to prevent such shifting in all possible ways."

ANSWER: In our opinion the effect of the tax-free clause in corporation bonds under the deduction-at-source provisions of the Income Tax Law is not a *shifting* but a *capitalization* of the tax. The DISCUSSION on this point has apparently fallen into the error pointed out by Professor Edwin R. A. Seligman, an eminent authority on taxation and the Chairman of the Income Tax Committee above referred to. In Professor Seligman's book, "The Shifting and Incidence of Taxation," page 4 of the introduction, he draws a careful distinction between shifting and capitalization as follows:

"To be contrasted in part at all events, with the shifting of taxation is the capitalization or amortization of taxation. The chief feature of this phenomenon—is the fact that under certain circumstances the purchaser of the taxable object, by cutting down the purchase price, discounts all the taxes which he may be called upon to pay in the future. If, for instance, the ordinary return on investments in securities is five per cent. and a tax of one per cent. is imposed on a particular kind of corporate bonds selling at par the price of these bonds will fall from par to eighty. The tax will be amortized or discounted through a depreciation of the capital value of the bonds by a sum equal to the capitalized value of the tax. The new purchaser thus escapes the tax which he is compelled to pay to the Government by giving so much less for the bonds.

The few writers who have discussed this phenomenon generally consider capitalization to be a kind of shifting. In a certain sense indeed there is a seeming justification for this view. For the pur-

chaser escapes the tax by throwing it off or shifting it backward upon the seller. In reality however a distinction ought to be observed between shifting and capitalization. Shifting implies a process applicable to a single tax or to a tax each time that it is imposed; capitalization implies a process applicable to a whole series of taxes and takes place *before* any of them, with the exception of the first, is paid. In case of a dealer who shifts a tax on a commodity back to the producer the process takes place each time the tax is levied, and the producer reduces the selling price each time by the amount of the tax. In case of capitalization the purchaser indeed pays the tax, but the initial possessor or vendor reduces the price by a sum equal to all the future taxes which the purchaser expects to be called upon to pay. In the one case we have the shifting back of a single tax; in the other case we have the throwing back of a whole series of taxes at once. For capitalization implies a change in price equal to the capital value of all anticipated payments. There is therefore a marked distinction between shifting and capitalization. If a tax is shifted it cannot be capitalized; if a tax is capitalized it cannot be shifted."

Professor Seligman refers also to the capitalization of a tax in his book "The Income Tax" published in 1911 and says on page 605:

> "If, for instance, the normal rate of interest on securities is five per cent., and a five per cent. bond has been selling at par and if a new tax of one per cent. per annum be imposed upon that particular class of securities, the price of the bond will fall from 100 to about 80."

In the illustration above referred to the one per cent. per annum means one per cent. upon the *principal* of the bond. The normal income tax amounts to one per cent. upon the *interest* of the bond. Applying the principle of capitalization to the normal income tax it would on this theory work out as follows:

The charge to the corporation that assumes to pay

the normal income tax of one per cent. upon the interest of a five per cent. bond is one-twentieth of one per cent. a year, so that instead of the corporation paying five per cent. per annum for the use of its money it is paying five and one-twentieth per cent. per annum. This one-twentieth of one per cent. capitalized would be about one per cent. of the face of the bond, or one point in its selling price. This would mean that a corporation in selling a five per cent. bond to the wholesaler would have to receive one point more for the bonds in order to capitalize the normal income tax of one per cent. To state it another way: If the owner of a five per cent. $1,000 bond had to pay the normal income tax on it he would receive an annual net return of $49.50 instead of $50. The result would be the fall of the bond's selling price to 99 which would net him about five and one-twentieth per cent. annually or five per cent. net after paying the tax. If the corporation failed to pay the tax its bonds would bring it one per cent. or one point less and instead of selling at par would sell at 99. If it agreed to pay the tax and received par for its bonds it received the benefit of the capitalization of the tax, and in assuming the tax under a tax-free covenant was out no more than it would have been by failing to assume it and receiving less for its bonds. If the capitalization of a tax of this character were unaffected by other economic factors this would be the advantage gained by the corporation in selling its bonds with a tax-free covenant and assuming to pay the normal federal income tax. Other factors enter into the problem of the sale price of bonds but the above illustration shows the trend of the effect of the tax and its capitalization.

3. DISCUSSION, p. 7. "Of course, the end sought, from the standpoint of the Government is to collect the tax in the most effective, and at the same time

the cheapest manner, but obviously this is only another way of saying the same thing, because what will work best with the taxpayer—assuming always that it be intended to enforce the law and not to allow it to be a dead letter as in the case of the general property tax—will work best from the Government's standpoint. The two parties to the proceeding are really equally benefited. Stoppage-at-source then is to be considered merely as a method and not as an end, the end being the collection of the full tax demanded by the statute."

ANSWER: The experience of England seems to justify the conclusion that collection-at-source accomplishes the desired result. The report of the Departmental Committee of 1906 appointed by Parliament to consider reforms in the English income tax law concluded among other things the following:

"Abandonment of the system of 'collection at the source' and adoption of the principle of direct personal assessment of the whole of each person's income would be inexpedient."

This report was made after an experience of about seventy-five years with the income tax in England collected at the source. Collection at the source was originated in 1803 and the law itself was not operative approximately between the years 1815 and 1842. The Committee of 1906 also said, referring to the graduation of the tax, that the assessment directly upon the income in its entirety would involve abandonment of the stoppage at the source principle, and referring to this principle further said:

"The importance of retaining a principle which is mainly responsible for the present development of the tax and the ease with which it is collected and the extreme undesirability of doing anything which would reduce its efficiency, can scarcely be overestimated."

Professor Seligman in his work on the income tax above referred to says on page 216:

"This" (stoppage-at-source) "is perhaps the chief cause of the great success of the English income tax."

4. DISCUSSION, pp. 7 and 8. "We must first of all briefly examine the English Income Acts to see if they in reality impose such a tax as we have been discussing. This examination will bring out the fact that these English acts proceeded *primarily* upon the theory that what was being reached was the *income as such* rather than the recipient thereof. A tax was imposed upon this income without any regard whatever to the situation of the recipient and in fact the emphasis is all the time upon the *'source.'* The tax is in reality laid upon the source with respect to income in his possession." "The tax is really not one single tax as with us upon the individual with respect to his *net income*, but rather a series of quite distinct taxes contained in separate schedules and levied upon *gross income.*"

ANSWER: The purpose of this statement is evidently to show that while collection-at-source is successful in England it would not be in the United States because the tax is of different character. In our opinion there is no difference in effect between the English Act and the Federal Income Tax Law and both are direct taxes upon net incomes, although the procedure of collecting the tax is somewhat different, ours being more considerate and more just in its administration. The English Income Tax is a direct tax upon the owner of the income. In the twenty-eighth report of the Commissioners of Inland Revenue of England it is stated:

"The tax affects a greater number of persons than *any other direct tax* could."

In the same report the following is stated:

"In 1803 the present system of *charging incomes* upon all property and profit at their first source was introduced." (Italics are ours.)

While the tax under the English Act is collected upon the gross income it is reduced to a tax on net income by a system of allowances, abatements and deductions elaborately set out in the act.

That the English Income Tax is a direct tax upon the owner of the income even though collected at the source, is clearly shown by Section 103 of the Act of 1842. Schedule A of the act provides that a tax shall be levied upon the ownership of lands, and under the ninth rule of Schedule A, shall be paid by the tenant if the tenant be in possession. The court, in the case of *Lamb* v. *Brewster* (1879), L. R., 4 Q. B. D., 607, in construing this portion of the act, regarding the payment of rent in full, said:

> "The substance of Sect. 103 is, that although the tax is levied upon the tenant who is in occupation, yet the *landlord is ultimately to bear the burden of it*, and that any agreement to the contrary is void. In order to cast the burden upon the landlord, it is unnecessary to hold that an agreement is illegal, if it provides that the tenant shall in the first instance pay the rent without deducting the tax, and that the landlord will subsequently repay him; *for the object of the statute is thereby fulfilled.*" (Italics are ours.)

It is unnecessary to quote further authorities to show that the English tax is a direct tax upon the income owner. It is also unnecessary to go into any discussion in regard to the Federal Income Tax being a direct tax. This was definitely settled in the case of *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S., 563. We consider the distinction attempted to be drawn in the DISCUSSION between the two acts is one of shadow and not of substance.

5. DISCUSSION, p. 9: "Besides this, and most important to remember, the English law, practically contemporaneously with the adoption of the plan of collection at the source, enacted extremely definite,

> distinct and effective measures to prevent shifting through contracts between debtor and creditor. All such contracts whether made prior to the enactment of the law or after, are made absolutely void and severe penalties are provided for failure to obey the statutory provisions and permit the required deductions."

ANSWER: In our opinion while this statement is true upon its face it does not have the effect upon English corporate financing that a provision in the Federal Income Tax Law prohibiting tax-free contracts in corporate bonds would have upon financing in the United States.

Section 103 of the English Act of 1842 provides in substance that contracts, covenants and agreements for the payment of certain incomes without allowing deductions are void. The prohibitions extend to rents paid by tenants under Schedule A, interest, annuities and dividends payable out of public revenue under Schedule C, payments made by the Government under Schedule E such as salaries, not taxed under Schedule C, and interest paid annually under Schedule D. The word "dividend" as used in reference to Schedule C is not a dividend as we understand it, that is, a dividend received on account of capital stock of a corporation, but interest upon public bonds which in England are called stocks. It is to be noted that the prohibition does not extend to dividends paid upon the shares of stock of English corporations. In England corporate financing is carried on principally by means of the selling of stocks or shares, the strict English Companies Acts having made it possible to finance through stocks in that country as we do through bonds in the United States. English railroads, for example, were built largely out of stocks with a small bonded debt, while in this country they were built out of bonds with the stock, in the early days, issued

largely as a bonus. Dividends in England payable free of the income tax have the same prominence that tax free bond interest does in the United States. A large part of the financing which is of a character of that obtained in this country through the proceeds of bonds, is obtained in England through the sale of preference or preferred shares and debenture shares. These shares, like preferred shares in the United States, bear fixed rates of interest and are practically loans. It is a settled principle of corporation law that preferred stocks are much in the nature of loans. Many authorities can be cited to this effect, but the principle is so well recognized that it is considered unnecessary to do so. An examination of the Stock Exchange Year Book for the year 1916, published in London, will disclose how common is the practice of paying such dividends tax free. By way of illustration, London & River Plate Bank, Ltd., paid up capital £1,800,000, pays its dividends tax free now even with the high rate of the income tax during the war; London City & Midland Bank, Ltd., paid up capital, £4,700,000, paid its dividends tax free until last year; North British & Mercantile Insurance Company, paid up capital £2,750,000, paid its dividends tax free before the war; British American Tobacco Co., Ltd., paid up capital £10,700,000, pays its dividends tax free even now. These are a few random examples of numerous cases of this character. It will thus be seen that the income tax law of England does not prohibit tax free income payments in the case of those securities which most seriously affect the nation's corporate financing.

III.

THE PRESENT ACT AND ITS METHODS OF COLLECTION.

1. DISCUSSION, pp. 12 and 13: "The withholding in our law is throughout not one really an *assessment* in the hands of the source which *at once* separates the income withheld while in the hands of the source and relieves him to that extent by direct statutory mandate from obligations which may be due his creditor. The sum withheld is rather a fund in his hands to be held by him as agent or referee, as it were, as a sort of security pending later and final action by the Government, resulting in an assessment and a consequent direction to turn over the amount to the Government in satisfaction of a tax upon the payee. It is thought that just here arises much of the dissatisfaction and confusion resulting from the operation of these withholding provisions in the case of our law."

ANSWER: After two full years' experience in acting as fiscal agent for corporations, involving the payment annually of about $12,000,000 of coupons for corporate bond interest, *we have failed to find a single case* where the full amount collected by us as the source was not assessed against us as fiscal agent at the close of the year in accordance with our returns to the Government. The statement above seems to us to embody a purely theoretical objection. In our opinion the advantage in our act in allowing the owner of income to claim his exemption at the time his income is paid to him by the source is a distinct advantage and is far better than the injustice of the English Act under which the Government collects the tax on his income whether he is entitled to exemption or not, and compels him to go through a process of claiming refunds in order to give him the benefit of his exemption.

2. DISCUSSION, p. 15: "To be sure, the taxpayer

> may be and is permitted by the law to file with the withholding agent his claim for relief from withholding to the amount of his individual exemption. But it is obviously impossible for him, until after the close of the tax year, to obtain any benefit from those provisions of the act which purport to relieve him from the operation of the withholding provisions in respect of deductions for expenses of transacting business, for taxes, for losses incurred in trade, etc."

ANSWER: This seems to us to emphasize a very minor point for the purpose of discrediting the enormous advantages that are obtained by means of the exemption certificates. The great bulk of exemptions are claimed on account of bond coupon payments and the number claimed by means of the annual income exemption certificate above mentioned we believe is infinitesimal in comparison.

> 3. DISCUSSION, p. 16: "Furthermore, all of this inconvenience, annoyance and injustice is incurred for the sake of collecting a relatively insignificant amount of the tax. We are informed that out of the total amount realized by the Government from the Income Tax in 1914, amounting to approximately $80,000,000, only $5,500,000 was collected at the source, the remainder being wholly assessed and collected on the basis of personal returns, either of individuals or corporations."

ANSWER: This does not seem a fair statement of the case regarding the collection-at-source feature of the act. The report of the Commissioner of Internal Revenue for the year 1914 above referred to shows the corporation tax collected as $39,144,531.71 and the personal income tax collected as $41,046,162.09. Out of this total the normal income tax was $16,559,492.93, and there was collected at the source a normal tax of $5,528,365.71. The only tax that it was possible to collect at the source, as the term is generally used, was approximately $40,000,000, of which approximately $25,000,000 was additional

tax collected through personal returns. The collections at the source amounted to practically one-third of the normal tax and one-eighth of the total personal tax. In its last analysis, however, the corporation tax must be considered as a tax upon individual stockholders collected at the source of their income, that is, through the corporation paying the dividends. This principle is clearly recognized in the exemption provisions of the Federal Income Tax Law by which stockholders are allowed to deduct dividends from their personal returns of income for the purpose of assessing the normal tax just as they are allowed to deduct their other income on which the tax has been collected at the source.

Professor Seligman recognizes this as a proper classification of the corporation tax in his work on taxation, saying, on page 526, that the Income Tax Law of 1894 made only two attempts to apply the principle of stoppage-at-source, corporations were to deduct the tax from dividends and the Government was to deduct it from the salaries of public officials. The only provision in the Act of 1894 relating to the *withholding* of a tax from dividends was a provision for a tax of two per cent. on the net profit of corporations and the individual in estimating his net income was allowed to deduct the dividends received from corporations liable to such tax upon their net incomes. This is precisely the same as in the present act and Professor Seligman's reasoning would be as applicable to the present act as to the Act of 1894. If this view of the case is tenable, then the Government collected at the source in 1914 over $44,600,000 of normal tax.

IV.

TAX-FREE COVENANTS AND SHIFTING OF THE TAX.

1. DISCUSSION, p. 17. "Unfortunately, income tax legislation in the United States, until the enactment of the present act, has failed to recognize the vicious nature of these covenants to pay without deduction and their destructive effect upon ability taxation, although we have in certain instances adopted methods involving in a qualified way, the principle of collection at the source."

ANSWER: Previous portions of the DISCUSSION, which have been commented on in another part of this ANSWER have stated that these covenants caused a shifting of the tax and have implied that they are bad and wicked. The DISCUSSION has failed, however, to point out any substantial evil that has flowed from such a so-called shifting and the statement that they are "vicious" is apparently gratuitous. We have shown, however, on the authority of the Chairman of the Committee to which the proponents of the DISCUSSION belong, that these covenants do not cause a shifting but a capitalization of the tax. As a matter of fact, Congress, not being properly educated upon the subject, probably did not see that such covenants were "vicious" or it would not have expressly recognized them as valid as it did in Section 122 of the Act of 1864 referred to in the DISCUSSION. Congress at that time probably considered that such contracts were the natural outgrowth of an economic situation in corporate financing following a collection-at-source provision of the law.

2. DISCUSSION, p. 17. "From an examination of very many corporate mortgages, we think it very clear that the history of tax-free covenants in corporate mortgage bonds in the United States dates from these provisions of the Civil War Income Tax Acts. The earliest instance of the clause which we have discovered is in a mortgage of the Jefferson Railroad (a Pennsylvania corporation) executed in 1868."

ANSWER: The history of tax-free covenants in corporate mortgage bonds of this country probably dates not from the provisions of the Federal Acts but from the peculiar laws of the State of Pennsylvania. If the authors of the DISCUSSION had discovered the mortgage of the Harrisburg, Portsmouth, Mount Joy & Lancaster Railroad securing its first mortgage four per cent. bonds, which mortgage was dated July 1, 1853, they would have found a provision to pay interest without deduction of any tax which the company was required to retain by the provisions of the law of Pennsylvania. The Philadelphia & Erie 4s issued under a mortgage issued in 1869 contain a similar provision relating only to the Pennsylvania law. Both of these mortgages are underlying mortgages of the Pennsylvania system and an examination of other underlying mortgages of the same system shows that subsequent to the Act of 1864 the tax-free clause was altered to include also United States taxes, and in other underlying mortgages of the same system was altered to include United States taxes and taxes, in one case of New Jersey, taxes of Maryland in another, and taxes of the District of Columbia in another. The permission to employ a tax-free covenant contained in the Act of 1864 probably was suggested by the practice in Pennsylvania mortgages. This would indicate that the recognition of the tax-free covenant by the Act of 1864 was a recognition of a contract between the parties natural and proper to equalize the effect of a tax on corporate financing.

3. DISCUSSION, p. 18. "As was pointed out in the Committee's report, the tax imposed by the Civil

War Acts referred to, was held by the Supreme Court of the United States to be, not an income tax upon the holders of the corporate obligations affected, but an excise tax upon the business of the corporation in respect of its interest payments, the company being merely granted the privilege of passing this tax on to the holders of its securities. In other words, the clause had its inception in this country, not as a means of shifting the burden of the tax from the person upon whom it was primarily laid to another person, but in order to avoid the provision of the act which permitted the corporation to shift *its* tax to the bondholder."

ANSWER: The Committee's report referred to cites *Railroad Company* v. *Collector,* 100 U. S., 595, and *United States* v. *Erie Railroad Company,* 106 U. S., 327. The syllabus of the decision in *Railroad Company* v. *Collector,* 100 U. S., 595, is as follows:

> "Tax on interest paid by corporations under Sec. 122 of the Internal Revenue Law as amended by the Act of 1866, is an excise tax on the business of these corporations, to be paid by them out of their earnings, income and profits."

In the opinion in the case Justice Miller says that the tax was not laid on the bondholder but on the corporation. How important is this decision may be inferred from the statement of Chief Justice Fuller who referred to it in his opinion in the case of *Pollock* v. *Farmers Loan & Trust Company.* He said as to its weight in determining what an excise tax is:

> "And Mr. Justice Miller in delivering the opinion said: 'As the sum involved in the suit is small and the law under which the tax was collected has long since been repealed, *the case is of little consequence as regards any principle involved in it as a rule of future action.*'" (The italics are ours.)

The case of *United States* v. *Erie Railroad Company,* 106 U. S., 327, was decided on the strength of *Railroad Company* v. *Collector.* The decision of *United States* v.

Erie Railroad Company was evidently reached after a great deal of discussion, and the syllabus does not say that the tax levied by Section 122 was an excise tax but says

> "railway company is liable to pay a tax of 5 per cent. on the interest which it has paid to non-resident alien owners and holders of its coupons and bonds."

Chief Justice Waite, in delivering his opinion on this case, does not say specifically that it is an excise tax on corporations, but in a short statement said that the case was decided on authority of *Railroad Company* v. *Collector.* Justice Bradley (Justice Harlan concurring) delivered a separate opinion in which he said the following:

> "I concur in the judgment of the court in this case, but not for the reasons given in the case of *R. R.* v. *Collector.* I concurred in the judgment in that case, as in this, on grounds essentially different than those given by the court. I always regarded the tax which by the 122nd section of the Internal Revenue Act of 1864 was laid upon the interest payable upon the bonds and upon the dividends declared on the stock, of railroad and other corporations, as a tax on the income *pro tanto* of the holders of such bonds and stock."

In his separate opinion Justice Bradley cited *Stockdale* v. *Insurance Company,* 20 Wall., 333, in which he, with Justices Waite, Strong, Davis and Field, expressed in separate opinions, that the tax was on the individual's income and not on the corporation.

Justice Field in an able dissenting opinion in *United States* v. *Erie Railroad Co.,* said:

> "The 122nd section of the Revenue Act of 1864 as amended by the Act of 1866, subjects the interest on the bonds of the company to a tax of 5 per cent. and authorizes the company to deduct it from the

amount payable to the coupon holder. The company is thus made the agent of the Government for the collection of the tax. It pays nothing itself; the tax is exacted from the creditor, or party who holds the coupons for interest. No collocation of words can change this fact."

Professor Seligman in his work on the income tax above quoted on page 444, says referring to the tax required by the Act of 1864 to be paid by corporations on dividends and interest on bonds:

"The dividend and interest tax and the salary tax, although separately mentioned, were really a part of the income tax. To this extent, therefore, the principle of stoppage-at-source was applied."

The above two cases cited in the DISCUSSION would thus appear to be feeble support of the contention there set out and Professor Seligman, the Chairman of the Committee citing them, evidently reached a different conclusion when he wrote his book on the income tax.

4. DISCUSSION, p. 18. "How far beyond its original scope the tax-free clause has gone and how unfortunate it is that its use was not prohibited at the start, is shown by the following typical form, taken from a recent indenture:

'Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessment or assessments, or other governmental charges, which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States or of any state, county, municipality or other lawful taxing authority therein.'

This clause appears in substantially this form with minor variations in the great majority of corporate mortgages made during the twenty-five years prior to the enactment of the present Income Tax Law."

ANSWER: We think that the above quoted form of tax-free clause is typical of the form in which it appears in the great majority of corporate mortgages. The object of the original tax-free clauses was to obtain the payment in full of the obligations containing such clauses. The holders of corporate bonds had seen tax acts framed to allow deduction of the tax from interest and conceived the idea that tax laws might be passed requiring a deduction of a tax at the time of payment of principal. Had the originators of the clause seen some of the provisions of inheritance inquisition statutes of some of the states, which often become effective when a bond at maturity stands registered in the name of a decedent, they might not have been criticized for including principal as well as interest in the covenant. As the matter stand the provision affects interest only under the Income Tax Law and we fail to see how anyone has been damaged by the breadth of the covenant.

5. DISCUSSION, p. 19. "Now, we think it proper at the outset to point out that the Government was not a party to these contracts; that they exist purely between the corporations and their creditors, and that agreements of this kind cannot in any view be held to control the action of Congress, if it determines from the standpoint both of efficiency and of the interests of the community as a whole, that it is sounder policy to impose the tax directly upon the recipient of the income."

ANSWER: We would agree with this statement provided Congress were to abolish the entire system of collection-at-source and it were not proposed by the DISCUSSION to substitute information-at-source. As will be pointed out in a later part of this ANSWER the substitution of information-at-source for deduction-at-source will have the same effect upon the market for corporation bonds that deduction-at-source has at the present time. It is a well known maxim of taxation that taxes should be administered in such a way as to least inter-

fere with trade conditions. If the effect and cost to the Government of information-at-source and deduction-at-source are practically the same, then Congress should, as a matter of public policy, carefully consider the effect of the tax-free clause upon corporate financing in the United States.

6. DISCUSSION, p. 20. "But we venture to suggest further that the one essential feature of the argument to which we have referred seems unsound. We think it cannot be demonstrated that the original purchaser of the tax-free bond paid, or that the corporation received, any ponderable consideration for the contracts referred to."

ANSWER: We do not know just how large a "ponderable consideration" is and we think it would be extremely difficult to prove in dollars and cents the consideration received by any corporation for the tax-free covenant in its bonds. It is, and has been since the early nineties, one of the covenants generally insisted upon as a result of the tax law in Pennsylvania and the threatened tax law in other states as well as the experience of investors under the Federal Act of 1864. The tax-free covenant is one of a number of elements which go to fix the price the corporation receives for its bonds, such as maturity, interest rate, sinking fund provisions, character of lien, place of payment, call provisions, and other essential elements that might be mentioned. It would be difficult to demonstrate that the original purchaser of any bond paid in dollars and cents any separable and definite part of the consideration for any of these essential elements, but to argue that any one of these elements is not an important factor in determining the price a corporation receives for its bonds would be to belittle the judgment of anyone having any knowledge of dealings in corporate securities.

7. DISCUSSION, p. 21. "We are inclined to the

view that these contracts, originating as we have pointed out at the time of the Civil War Acts, were continued by mere *inertia*, so to speak, as the clauses permitting trustees in such mortgages to enter and operate, and conferring upon such trustees strict power of sale which, while universally incorporated, are never resorted to in practice."

ANSWER: The general history of the tax-free clause in the United States may be illustrated by referring to its occurrence in the mortgages of three large systems. In the examination of twenty-nine mortgages of the New York Central Railroad Company and its controlled lines, seven were issued from 1874 to 1890, and of these seven only one had the tax-free clause. Of the remaining twenty-two which were issued from 1890 to June, 1913, all had the tax-free clause but one, which was issued in 1892.

In our examination of twenty-eight mortgages of the Atchison, Topeka & Santa Fe Railroad and its controlled lines, we found seven were issued from 1879 to 1890, and of these none contained tax-free clauses. Of the remaining twenty-one, which were issued from 1890 to 1914, all but five had the tax-free clause, and one of these, issued in 1914, covenanted to pay free of all taxes but the Federal Income Tax.

In the examination of twenty-three mortgages of the Southern Railway and its controlled lines, twelve were issued from 1879 to 1890. Of these, four had the tax-free clause and eight had not. Of the remaining eleven, from 1890 to 1914, all had tax-free clauses except the one issued in 1914, which was tax free except as to the Federal Income Tax.

If these clauses were inserted through mere inertia why were they less prevalent as shown by the above statement, and by the statement made in the DISCUSSION

between 1871, the time of the expiration of the Federal Income Tax Law, and 1890? And why are they common from 1890 until now? About 1890 agitation for an income tax law commenced and provisions were inserted for a progressive income tax in the platform of the Populist party and such a law was advocated in farmers' conventions. This caused apprehension in the minds of dealers in corporate bonds that an income tax law might be passed and having in mind the provisions of the Civil War Acts by which bondholders were taxed at the source on their bond interest, they inserted this clause in bonds issued from 1890 onward. Some corporations, however, were able to float their bonds without the insertion of the tax-free clause in their mortgages. The above agitation resulted in a passage of the income tax law of 1894 and the subsequent decision in the case of *Pollock* v. *Farmers Loan & Trust Company* which declared it unconstitutional. Immediately following the Pollock case an agitation was commenced for a constitutional amendment culminating in the adoption of the amendment and the passage of the Federal Income Tax Law of 1913. There has been hardly a time since 1890 when the agitation for the income tax has not been a present and prospective factor in corporate financing. The history of the tax-free covenant as shown on the above three railroad systems clearly bears this out. It is a significant fact that out of 9,208 issues of bonds, concerning which statistics were obtainable regarding tax-free clauses at about the first of the year 1915, 6,297 contained the tax-free clause and 2,911 did not. If a community were fortunate enough to escape the burning of a single building over a period of years would the owners of the buildings in that community be considered the victims of "inertia" because of continuing to carry fire insurance?

8. Discussion, p. 21. "Of course since the enactment of the present law, which followed almost immediately, the making of such contracts is expressly forbidden."

Answer: There has been much doubt in the minds of lawyers versed in corporation bond law as to whether or not the present act does prohibit tax-free contracts. While we have not had an opportunity to examine any considerable portion of mortgages executed since the Federal Income Tax Law went into effect, it is significant to note that of 178 corporate bond issues brought out in 1915, 100 of them contained no tax-free provision and 78 of them contained such a provision. It is further interesting to note that of the 100 failing to contain a tax-free provision, 51 were railroad issues, and of the 78 containing a tax-free provision, only 11 were railroad issues.

9. Discussion, p. 22. "We are aware also that attention has been called to the prices of certain issues consisting of two forms of corporate bonds which are identical in all other respects, both as to rate of interest, date of maturity, security, etc., and differ only in that some portions of such issue contain, and others do not contain, the tax-free covenant as to the present tax. It is claimed that these prices show that the contract has a present value and that presumptively, therefore, value was paid for it when made. One such issue is the Chicago and Northwestern Railway Four Per Cent. General Mortgage Bonds, maturing in 1987. Certain of these bonds issued prior to October 3, 1913, contain the usual tax-free clause. Certain others, secured by the same mortgage, but issued subsequent to that date, are non-tax-free as to the Federal Income Tax. These bonds are said to be quoted at a price for the tax-free about one per cent. in excess of the price for the non-tax-free bonds. An examination of the published quotations of prices at which these particular bonds have sold since the first of January, 1916, shows that the highest price during this period for the non-

tax-free bonds is 96, while the highest price for the tax-free bonds is 95⅝. If the argument advanced is sound, it would seem that the tax-free bonds should have sold at a substantially higher price than the non-tax-free bonds. The quotations certainly do not seem to support this view."

ANSWER: An examination of the quotations on these bonds from the time of the re-opening of the Stock Exchange in January, 1915, to June 18, 1916, as shown by the Commercial and Financial Chronicle establishes clearly that the tax-free bonds sell higher than the non-tax-free bonds of the same issue. The prices quoted in the DISCUSSION are the high range prices for the year 1916 and are worthless for purposes of comparison. The sale and bid prices from week to week where simultaneous quotations occur should be used to determine the facts. Prior to the opening of the Stock Exchange after the war, tax-free bonds and non-tax-free bonds of this issue were not quoted separately. The Chronicle of December 12, 1914, quotes a sale of these bonds tax-free at 89¼, and on the same day non-tax-free bonds at 89. The following quotations on the following dates indicate the general trend of the comparative prices of these bonds:

Date	Tax-Free	Non-Tax-Free
February 11, 1915	Bid 92⅝	Sale 92⅞
February 19, 1915	Bid 92⅝	Sale 92¼
February 26, 1915	Bid 92½	Bid 90¾
March 5, 1915	Bid 92⅝	Bid 91½
March 12, 1915	Bid 93¼	Bid 91½
March 26, 1915	Bid 92⅝	Bid 90½
April 1, 1915	Sale 94	Bid 92
May 7, 1915	Sale 94	Bid 93
May 14, 1915	Bid 94	Bid 92
May 21, 1915	Sale 94⅛	Bid 93½
June 4, 1915	Bid 94¼	Sale 93½
June 25, 1915	Sale 93⅛	Bid 92
August 6, 1915	Bid 93⅛	Bid 92
December 3, 1915	Bid 96	Bid 95
February 11, 1916	Sale 95	Sale 94

The quotations shown on dates selected at random sufficiently refute the figures cited in the DISCUSSION and the difference in price between the tax-free and non-tax-free bonds indicates emphatically the value of the covenant and the truth of our contention.

10. DISCUSSION, p. 23: "If, prior to the effective date of the act, bondholders paid an additional price for the tax-free covenants as a sort of insurance against the possibility that at some time or other in the future a tax would be levied collectible at the source, why should not the corporation which purchases bonds at the present time be also willing to pay an additional price as a protection against the possibility that in the future the tax might be collected at the source against corporations as well as against individuals?"

ANSWER: The DISCUSSION asks the question as if it were stating its substance as a fact. In reality corporations purchasing bonds even for their own use seriously consider this matter and consider the tax-free covenant an important element in judging the price. Where they are purchasing only for resale, they consider the tax-free clause as one of the most important elements in fixing the price of purchase. A cursory examination of the advertisements and bond circulars of the principal bond selling bankers and firms throughout the United States and the manner in which the payment of the income tax is emphasized in these circulars is a sufficient answer to the query or to the statement, if it is intended to be one.

11. DISCUSSION, p. 23: "It may well be that an individual who to-day purchases bonds knowing that he is *now* subject to collection at the source of the one per cent. normal income tax may be willing to pay slightly more for a bond which contains a covenant which relieves him from the certainty of the *present* tax. We do not wish to be understood as claiming that he would not pay something for the exemption."

ANSWER: This statement made in the DISCUSSION clearly indicates that its writers realize the futility of the argument attempted to be advanced in it and that their case is without foundation.

12. DISCUSSION, p. 27: "The Government is doubtless collecting the thousands of dollars from debtor corporations which represent taxes computed on amounts of gross income of bondholders who have, to the extent of all or part of the payments, no taxable net income whatever."

ANSWER: No cases are cited in the DISCUSSION or estimates made either at large or on the part of any specific corporation to show that the practice is at all general or has reached any appreciable amount. We think, from our experience in handling income tax certificates for thousands of bondholders and from the experience of other banks with whom we have discussed the subject, that the great majority of bondholders are fair in claiming their exemptions and if they are not subject to the income tax have no reason to and do not attempt to take advantage of the tax-free covenant.

The individual, however, who has two or more classes of income, all of which are taxable, undoubtedly does exercise his privilege to use the tax-free covenant and there is no reason why he should not if he so chooses. The covenant was made for his advantage and benefit and he has a legal and moral right to use it. We have heard little complaint of this character except through the efforts of those corporations who seem to be working together under a short sighted and economically mistaken policy with the idea they are saving money by preventing the use of the tax-free covenant.

13. DISCUSSION, p. 27: "Yet the effect of the tax-free contracts coupled with the provisions for collection at the source do enable this class of income" (fixed investments of wealth in corporate securities) "not only to escape taxation but to shift the burden of taxation which it was intended that its recipient should bear, upon an entirely different portion of the community."

ANSWER: Only the normal tax is affected by the tax-free covenant. If an individual's wealth in investments of this character return him an income of over $20,000 a year it is reached by the surtax with which the tax-free covenant has nothing to do. The surtax applies to coupons from corporate bonds as well as the other securities prescribed in the act.

14. DISCUSSION, p. 28: "As has been pointed out by one of the members of the Committee,

'The consequence is that as the present law compels these corporations to withhold the income tax on the coupons, the corporations under the tax-free clause have no option but to pay the tax themselves. As a result the government is hitting the wrong man. It seeks to impose the tax upon the bondholder; in effect, it mulcts the corporation. Under the present situation, the tax due by such corporate bondholders is paid by the stockholders.' (Seligman, The Income Tax, page 695.)"

ANSWER: The corporations agreed to pay the normal tax and sold their bonds on that basis. This being true how can it be said that they are "mulcted"? The tax has been capitalized and paid for. The use of exemption certificates is driving investors to place their money in corporate stocks, municipal bonds and mortgage notes where no certificates or disclosure at the source is required. The tax-free clause is, outside of a sufficient interest rate, the only argument left as an offset or inducement that may be offered to hold the investor in corporation bonds. The abolition of this clause will seriously narrow the market for such bonds. If this inducement is taken away the only practical recourse would be to raise the interest rate on corporate bonds.

The stockholders and directors of most corporations are glad to pay for the privilege of retaining a proper market for their bonds. There seems to be no reason why the borrower by means of corporate bonds who sees the market for his securities constantly narrowed by the effect of the Income Tax Law and who sees as an alternative a raise in the rate he must pay on his securities in order to equalize the market as against other securities mentioned, should not be allowed to equalize the situation by private contract which meets with no objection by anyone but a class of corporations whose market is most stable and least affected by the situation. The larger industrial corporations and public utility corporations and even many railroad corporations have had a broad enough vision of the financial situation created by the act to see its effects and to agree voluntarily, since the act has gone into effect, to pay the normal tax upon interest on their bonds. Drawing illustrations from only a few of our own experiences we may say that Swift & Company in putting out its issue of $25,000,000 of bonds last year took this position without a moment's hesitation. The J. I. Case Threshing Machine Company who issued $12,000,000 of bonds in 1914 took the position at first that they proposed not to pay the normal tax because of their doubt as to the validity of such a contract, but many of their bondholders, before the first interest payment, started so much correspondence on the subject that when the company saw how the situation was affecting the market of its securities it voluntarily changed its position and agreed to pay its coupons tax-free.

The Commonwealth Edison Company, which supplies the great part of the electric lighting and power in the City of Chicago has outstanding $34,600,000 of its First

Mortgage Gold Bonds dated September 1, 1908. There was great doubt whether or not the mortgage securing these bonds provided a tax-free covenant. Appreciating the desirability, however, of maintaining the market for its bonds, this company, before its first interest date after the income tax law was passed, published the following advertisement in the Chicago press:

"COMMONWEALTH EDISON COMPANY
INTEREST

The semiannual interest due March 1, 1914, on the First Mortgage Gold Bonds of this Company is payable at the Illinois Trust and Savings Bank on and after that date. Such interest will be paid in full, and where the provisions of the Federal Income Tax Law relative to the deductions of the so-called normal tax requires said tax to be deducted from such interest because the bondholder is taxable, such deduction will be made good by the Company.

COMMONWEALTH EDISON COMPANY,
EDWARD J. DOYLE,
Treasurer."

The Commonwealth Electric Company, having an issue of $8,000,000 of bonds, published practically the same announcement. Other instances might be cited in which large corporations have followed the same course. The agents of the stockholders—the directors—(most of whom are large stockholders) of these corporations are men of business ability and acumen and think they are benefiting and not "mulcting" their stockholders by such a course.

V.

COST OF ADMINISTRATION OF COLLECTION AT SOURCE.

1. DISCUSSION, p. 29: "It will thus be seen that the Treasury Department singles out and especially condemns the withholding features of the present law."

ANSWER: From all the information we can obtain the Secretary of the Treasury in making the recommendation referred to in the DISCUSSION did so as a result of general impressions in the Internal Revenue Department. In our opinion the system had not been in operation sufficiently to afford an experience broad enough to be a basis for the recommendation above referred to. The Commissioner of Internal Revenue said in his annual report for the fiscal year ended June 30, 1915, page 23:

> "The information to be obtained from individual returns as now required by law, in conjunction with the withholding features of the law, is so incomplete as to the gross incomes received by individuals that it would be difficult to make a statistical report that would be of practical value to those concerned in problems of taxation or other economic questions."

2. DISCUSSION, p. 30: "The ratio of cost of tax collected or assumed ran all the way from 2 per cent. to 50 per cent. and the average for 1914 was approximately 15 per cent."

ANSWER: We think that a cost of from fifteen to fifty per cent. upon the corporation collecting the normal tax upon interest coupons does not denote an oppressive state of facts if either collection-at-source or information-at-source is to be retained as an administrative feature under the Income Tax Law. We would prefer the abolition of both systems, but we concede that as taxation is regarded in the United States probably the collection-at-source system will have to be retained. The general charge by fiscal agents is from one-sixteenth to one-eighth of one per cent. on the amount of coupons paid. On a $10,000,000 bond issue of five per cent. bonds the annual interest would be $500,000. The fiscal agent's charge at the above rate of one-eighth of one per cent. would be $625.00 per year. The normal tax on the above interest would be $5,000 a year. If this corporation is a railroad corporation it saves, on a basis of average investigations made, about seventy-five per cent. of this $5,000, or $3,750, leaving $1,250 of tax to be paid under its tax-free covenant. On the basis of the above charge this would cost the corporation for administration about fifty per cent. of the tax collected. In the case of industrial and many public utility corporations, investigation shows that about fifty per cent., or $2,500, of the $5,000 would be saved, and in such case the collection cost would be about twenty-five per cent. of the tax collected. The distinction between industrial and railroad costs is due to the fact that the railroads have a broader and more established market for their securities and they place them in large blocks in corporations such as savings banks, trust companies and insurance companies and with non-resident aliens who are unable to take advantage of the tax-free clause.

A great part of the cost of administration of the tax has been brought on by the corporations themselves. The law originally contemplated certificates of exemption to be filed only when exemption was claimed. In order to save the burden of the tax-free clauses the corporations sent their representatives to the Treasury Department at the time the first regulations were being framed and asked that a compulsory ruling be made requiring certificates to be filed with all coupons from

corporation bonds. We do not complain of this, but it resulted in a more complicated system of administration. The result is that the higher the cost in proportion to the tax collected the more the corporations save on their tax-free covenants. In the above illustration the corporation paid $625.00 annually to save $3,750 in one case, and $2,500 in the other. Certificates under information-at-source system would cost practically as much to handle, but suppose they cost only one-half as much, then the corporation would be charged $312.50 annually to save $5,000 or the full normal income tax, because under the information-at-source system the tax-free covenant would not be effective. This would be a cost of $312.50 a year for the collection of no tax at all. We do not know what *fearful rate* of cost the proponents of the DISCUSSION would complain of in such case, but they seem perfectly satisfied to endeavor to bring about such a condition. As a matter of fact most of the large industrial and public utility corporations are glad to pay the normal tax together with the collection cost in order to save the market for their bonds and to put their bonds on a nearer equality with stocks, municipal bonds and mortgage notes in the eyes of the investor. Using the above illustration as a basis, the cost to the corporation, if a railroad corporation, of assuming the normal tax plus the cost of administration would be about 5.019 per cent. on its bonds annually; and if the above corporation is an industrial corporation, such cost would be about 5.031 per cent. on its bonds annually. In our opinion this increase over their interest charge is what the corporations ought to be glad to pay to equalize the market for their bonds. We think that if the tax-free covenant benefit were lost that corporations would have to increase their interest rates more than this to effect such an equalization.

3. DISCUSSION, p. 31: "Enough has been said we think to demonstrate our contention that at least in the case of bond interest the present system of withholding should be abandoned and some less expensive method substituted."

ANSWER: Little has been said in the DISCUSSION regarding the withholding on rents, salaries and other fixed and determinable annual incomes. The withholders in these cases seem to be left without champions. The DISCUSSION recognizes the elusive character of bond coupon income and is obliged to recommend a clumsy and inefficient system of information-at-source casting additional burdens on withholding agents of this and other income in order to escape the effect of the tax-free covenant.

VI.

RECOMMENDATION OF INFORMATION AT SOURCE.

1. DISCUSSION, p. 32: "The Committee has recommended the substitution of what has been termed information-at-source. As the name implies, this aid to the collection of personal income tax is nothing but the using of the most natural method."

ANSWER: Under the present law and regulations the source is fairly well defined. In cases of miscellaneous income and income received through fiduciaries, withholding is required only where the payments exceed $3,000. In the case of interest on corporate or other obligations of a certain character and in the case of what is known as "foreign items," the deduction is made irrespective of the amount of payment. This distinction has been made after a careful study by the framers of the act of the responsibility of the source of income in each of these classes and the facility with which the deduction and collection could be made. It results that

under the present plan deduction is the first consideration and information is the second. If information-at-source were substituted, the fact that information would be the sole consideration would destroy the reason for the distinction between income payments of over $3,000 and those of less amount. If information is the sole consideration the logical conclusion is that the information must be as complete as practicable. If it is not complete, it is practically worthless. It would still be necessary for the Government to obtain information as to the ownership of the enormous income payments represented by bearer coupons. If information were substituted for deduction, all income must be placed in substantially the same class as that from corporation bonds and foreign items. It would cause the limit of $3,000 to be removed in the case of miscellaneous income and income received through fiduciaries. It would follow that payments of rent, interest on mortgage notes and commercial paper, salaries, wages, and other fixed payments, would necessitate information certificates at the source of payment. If this were so the returns to the Treasury Department would be enormously multiplied and the burden and cost to the Government and individuals would be enormously increased. All persons who now make returns to the source would still have to make returns, and additional returns would be represented by the great mass of payments which run from $3,000 down to the necessary minimum limit. The National Tax Association in the report of its Committee recognized this diffculty and suggested that the limit would have to be lowered to about $800. The Treasury Department officials, without prejudice and in informal discussion, have recognized this difficulty and have suggested that the limit would have to be reduced to some-

where around $1,000. Information-at-source means information from the source of income. The source has no knowledge of the ownership of income in most cases, except as it is furnished by the income owner and in order to make any representation to the Government that would be at all accurate, the source must be furnished the information by the owner. The great volume of such information would have to be furnished by the owners of interest coupons payable to bearer. It would be impracticable to obtain this information except by certificates or other information statements accompanying the coupons or other items. This would require, so far as these particular items are concerned, as much work as at the present time except that of computing and making deductions, which, in our experience, is a very small proportion of the cost involved. The examination of statements to ascertain compliance with the regulations would still be necessary by the source. The cost to corporations paying coupons and like obligations would probably be lessened very little and the paying agents would still have the burden of the work and would be obliged to pass the added expense to their principals. In order to enforce the provisions for furnishing information statements in the case of bearer coupon payments and other income payments of the character not disclosing the owner, it would be necessary that some penalty be provided for refusal or neglect to furnish the information. The practical working penalty at the present time is that of having the normal tax deducted. If this were still to be exacted it might render deduction necessary in some cases with the result that the various sources would be obliged to hold out and return to the Government various sums of small amount which would call for almost as much working

machinery as is required by wholesale deductions under the present plan. About the only other practical remedy available would be refusal of payment of the items, which would engender friction and delay in handling such transactions and would disturb the business relations between the source and owner of the income, which is a standing source of friction even under the present plan.

2. DISCUSSION, p. 34: "Under a system of information-at-source, only one form would be required instead of the seventeen forms above mentioned. Furthermore, the matter in the single form would be considerably cut down by reason of the fact that it would not be necessary to incorporate any matter with reference to a claim or otherwise of individual exemption."

ANSWER: Of the forms referred to in the DISCUSSION only nine are exemption certificates relating to coupons on corporation bonds. Those shown as numbers 1007 and 1008 relate to miscellaneous income, and forms numbers 1012, 1012a, 1012b, 1012c and 1012d are only pages of one monthly return which is really a letter from the fiscal agent to the Government transmitting the certificates and showing the tax withheld. The DISCUSSION in this connection fails to refer to the most important part of the certificate system, that is the color scheme by which the fiscal agent in determining whether to withhold or not to withhold the tax is governed by the color and not the form of certificate. All certificates claiming exemption are printed on yellow paper and all those not claiming exemption are printed on white paper. The fiscal agent in receiving a certificate first determines that it is properly made out. He secondly determines whether or not it does or does not claim exemption. This he can determine by the color of the certificate alone and so far as the fiscal agent is concerned,

although nine different kinds of certificates are used, the effect is the use of only two. In this connection we are of the firm opinion that the complexity and cost of the exemption certificate situation can be materially reduced. A special committee of the Investment Bankers Association has under consideration at the present time plans which the Treasury Department is inclined to consider favorably, which we think will reduce the cost and work in handling these certificates and will simplify the situation. The substitution of information-at-source for deduction-at-source would mean more work for the Government but the debtor corporation would eliminate only the cost of the tax-free covenant and handling of the tax collected. The Government is getting the *tax* and *information* under the present plan and at a probably higher cost would get only *information* under the proposed substitute.

3. DISCUSSION, p. 36: "By requiring the certificates or reports in every case of payment of interest on corporate bonds and similar obligations and by fixing at say two-thirds of the minimum exemption the amount to be reported of income of other character, the Department will be in possession of considerable more information than it possesses at the present time."

ANSWER: It is to be noted that the recommendations of the proponents of the DISCUSSION recognize the necessity of using more certificates and that they do not agree with the recommendations of their own tax committee nor with the ideas of the Treasury Department. This point has been fully discussed in the next preceding paragraph numbered 1 of this ANSWER.

Conclusion.

The Answer has endeavored to consider only the principal points made in the Discussion. The Answer is naturally made to controvert the statements in the Discussion, but it is done because we consider that the situation is a very serious one as affecting the market in the United States for bonds of corporations.

1. We believe that collection-at-source as administered in the Federal Act does not affect the levying of taxes according to the ability of the taxpayer.

2. We assume that collection-at-source is necessary on account of the disposition of taxpayers to understate or misstate income.

3. We do not think, if either collection-at-source or information-at-source is necessary, that collection-at-source results in any more complication, hardship and unwarranted expense than the economic situation renders necessary.

4. In our opinion the tax-free covenants do not cause a shifting of the tax as such an expression is understood by economists, but causes a proper capitalization of the tax rendered necessary by the economic situation created by the Income Tax Law.

5. If Congress considers that the expense and cost of administering the collection-at-source feature of the income tax law is practically the same as that of information-at-source, then it should consider the effect of the two systems upon the corporations throughout the United States in conducting their financing.

6. We think information-at-source will have the effect of further narrowing the market for corporation bonds, which will probably result in the increase in rates of interest that corporations must pay on their bonds effective long after a possible repeal of the act, and that it will cost the Government practically as much as the present system.

7. Information-at-source will necessitate all of the machinery employed in collection-at-source and in addition will cause enormous numbers of persons who do not have to disclose at the source, to make disclosures, thus increasing public irritation against the law without any appreciable benefit over the present system and without relieving any of its present complications.

8. The Government by the present plan obtains both the collection of a substantial part of the tax and information which enables it to check all of the present returns. Why should it abandon such a system for one which will cause more widespread dissatisfaction regarding the act and give the Government only one of the returns, that is, information, which it is getting at the present time, and which will have a serious effect upon corporate financing in the United States?

9. We think Congress should repeal the provision in the act which some lawyers think prevents the tax-free clause in bonds issued after the act goes into effect, and should leave this to be a matter of adjustment between bondholders and the borrowing corporations.

10. We think there is little demand for change from collection-at-source to information-at-source, or for the prevention of the tax-free covenants by the law except from a limited class of corporations.

Respectfully submitted on behalf of The First National Bank of Chicago, and the First Trust and Savings Bank, Chicago.

Roy C. Osgood,
Counsel.

END OF
TITLE